Internal Revenue Service

memorandum

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date: JUL 27 1987

to: District Counsel, Chicago CC:CHI
Attn: Beth L. Williams, Special Trial Attorney

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This memorandum serves to respond to your request for technical advice, dated June 23, 1987, and to make additional suggestions for the purpose of writing the Government's brief for this case.

ISSUES

(1) Whether the application of the step-transaction doctrine by the Government should be reasonably foreseeable by the taxpayer in order to be invoked by the Government.

(2) Whether corporate level tax should not be recognized by [redacted] because the [redacted] transaction served to effect an in kind distribution of an operating business that simultaneously resulted in an equity contraction of the [redacted] corporation. (per [redacted]'s written analysis of section 311(d)(2)(B)).

DISCUSSION

ISSUE I

You have asked us to comment on the question asked by Judge [redacted] at trial with respect to the need for the foreseeability by a taxpayer of the application of the step-transaction doctrine to the facts of his case as a requirement for its invocation by the Government.

We believe that this broad question can be argued to be moot in the context of this case, because in any event the application of the step-transaction doctrine to this case was clearly foreseeable. The record for this case indicates that at the time the instant transaction was structured [redacted]'s attorneys were well aware of the risk of the Government attempting to apply the step-transaction doctrine to restructure the form of this transaction. In general, the application of the step-doctrine transaction is foreseeable whereever the form of the transaction

does not accord with its economic substance and the form adopted by the taxpayer was motivated primarily to avoid tax. It is well established by the case law that a transaction may be "stepped" to accord with its economic substance where the form chosen by the taxpayer was motivated primarily by the avoidance of tax. See, Gregory v. Helvering, 293 U.S. 465 (1935), XIV-1 C.B. 193; Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970), cert denied, 401 U.S. 939 (1971). Hence, since we believe that [redacted] had chosen for tax avoidance purposes to cast its transaction in a form that did not comport with the economic substance of the transaction, it was reasonably forseeable, given the case law, that the the Government would utilize the step transaction doctrine to recharacterize the [redacted] transaction. That is, it is foreseeable that the Government would tax a transaction in accord with its economic substance, instead of a form adopted by the taxpayer to avoid tax.

The forseeability of the application of the step-transaction doctrine is simply a function of the applicable case law. The step-transaction doctrine like many tax doctrines (like the assignment of income doctrine and the tax benefit rule) is a judicially created concept. Tax law generated by case precedents is as much a part of the tax law as that provided by the statutes, i.e., the Internal Revenue Code. Thus, in ascertaining the tax implications from a given transaction a taxpayer must not only consider the relevant statutes, but must also consider the relevant case law, as well. Hence, Judge [redacted]'s comment about a party's right to rely on the express wording of the statute is easily answerable by asserting that a taxpayer is put on notice by the case law as well as by the statutory law. As such, it can be asserted that if a transaction should, under the case law, be recharacterized then it can be said that it was reasonably foreseeable by the taxpayer that such recharacterization would be made.

In any event, we are not aware of any case that requires reasonable foreseeability as a sine qua non for invoking the step-transaction doctrine. Moreover, we are not even aware of any case that requires foreseeability as a sine qua non for invoking any judicial tax doctrine (like the tax benefit rule or the assignment of income doctrine).

ISSUE II

You have also requested our comments on [redacted]'s analysis of section 311(d)(2)(B), since you expect that analysis to be advanced in the petitioner's brief for this case. [redacted] concludes that there should be no corporate level gain recognized by [redacted] from the transfer of its [redacted] shares to

[redacted], based on his conclusion that the transaction not only fits the language of section 311(a) and 311(d)(2)(B), but is consistent with what he believes to be the policy of section 311(d)(2)(B). [redacted] argues that the policy of section 311(d)(2)(B) is to relieve corporate level tax where the stock of a long-held, operating subsidiary is distributed to shareholders and such distribution results in a contraction of equity capital, as evidenced by a redemption of the outstanding shares. Such nonrecognition treatment he argues parallels the nonrecogniton treatment afforded a corporation under section 336 for a partial liquidation. Hence, [redacted] appears to argue that since the [redacted] transaction effected a distribution in kind of an operating business (per the distribution of the [redacted] stock) and at the same time caused a contraction of [redacted]'s equity, [redacted] should thereby be excused from the recognition of the corporate level tax because, he contends, that the [redacted] transaction complies with the policy of section 311(d)(2)(B).

We are unable to ascertain the policy behind the enactment of section 311(d)(2)(B). We believe, however, that the instant case does not turn on the policy behind section 311(d)(2)(B). The Government's position in this case is much broader in that it rests on whether [redacted]'s disposition of its [redacted] stock is even subject to the rules of section 311. That is, the general rule of section 311(a) states that no gain or loss shall be recognized to a corporation on a distribution of property with respect to its stock. Thus, the pivotal question is whether [redacted]'s conveyance of the [redacted] stock to [redacted] was, within the intendment of section 311(a), a distribution of property with respect to the [redacted] stock. Treas. Reg. § 1.311-1(e)(1) interprets that requirement as limiting the scope of section 311 only to distributions which are made by reason of the corporation-stockholder relationship. Moreover, this is expressly stated by Congress in the legislative history behind section 311(a). S. Rep. No. 1622, 83rd Cong. 2d Sess. 247 (1954). Clearly, if the [redacted] stock conveyance is afforded taxable sale treatment, as falling outside of the general nonrecognition rule of section 311(a), then section 311(d)(2)(B) and the policy behind it should not be relevant to the outcome of this case. Stated another way, the general policy surrounding section 311, as a whole, of limiting the application of section 311 only to distributions which are made by reason of the corporation-stockholder relationship must necessarily preempt any policy behind a subsection of section 311 i.e., subsection 311(d)(2)(B).

We now offer some general comments on how best to argue the instant case.

We believe that the Government's primary argument in this case should be that the [redacted] transaction is not within the scope of section 311, since the [redacted] stock was not conveyed by [redacted] to [redacted] "in a distribution with respect to its stock," within the intendment of section 311. That is, [redacted] received its own stock as consideration for the sale of its [redacted] stock to [redacted] and the

redemption by [redacted] is independent of that sale. Such argument can rely on the legislative history behind section 311, Treas. Reg. § 1.311-1(e)(1), the regulatory examples provided in Treas. Reg. § 1.311-1(e)(2), and old case law, without resorting to arguing the step-doctrine transaction or arguing that [redacted] was never in substance a shareholder of [redacted].

The legislative history behind the initial enactment of section 311 provided that section 311 was intended to exempt corporate gain on distributions only when they were made to shareholders as shareholders and not in any other capacity. Moreover, that legislative history also provided that the nonrecognition rule set forth in section 311(a) was not intended to alter existing law with respect to the distribution of appreciated property, where such distribution is made to a shareholder in a capacity other than that of a shareholder. S.Rep. No. 1622, 83rd Cong. 2d Sess. 247 (1954). In accordance with that legislative history, Treas. Reg. § 1.311-1(e) provides generally that section 311 only applies to distributions by a corporation to its shareholders which are made by reason of the corporation-shareholder capacity. It then provides specifically that gain is to recognized by a corporation where a corporation receives its own stock as consideration upon the sale of property. Example 2 of Treas. Reg. § 1.311-1(e)(2) provides an example of where a corporation sells property to an individual who pays for the property with shares of stock of the corporation. The example indicates that the sale of property by the corporation for its stock is effectively to be treated as if the corporation had received an amount of cash equal to the fair market value of the stock received.

Finally, we note that the examples set forth in Treas. Reg. § 1.311-1(d)(2) are supported by old case law. As previously noted, the legislative history behind section 311 expressly provided that it was not intended that existing law was being altered for situations where appreciated property is conveyed by a corporation to its shareholders in a capacity other than that of a shareholder.

In the case of Commissioner v. S.A. Woods Machine Co., 57 F.2d 635 (1st Cir. 1932), the appellate court held that a corporation realized taxable gain where it received its own shares of capital stock in settlement of a patent infringement suit. Our review of the Treasury Decision file assembled in connection with the promulgation of Treas. Reg. § 1-311-1(d) has revealed that this case was the basis for example 1 of that regulation. In the case of Commissioner v. Boca Ceiga Development, 66 F.2d 1005 (3rd Cir. 1933), the appellate court held that a realty corporation realized taxable gain on the sale of its land to its stockholder, notwithstanding that payment was made with the corporation's own stock. In both cases, the appellate courts treated the exchange transactions as being equivalent to the payment of the debt in cash and the investment of the proceeds by the corporation in its own

stock. Both appellate courts emphasized that the stock of the corporation was simply being used as a payment medium. Clearly, the record in this case establishes that [redacted]'s transfer of the [redacted] stock to [redacted] was pursuant to a vendor-vendee relationship and [redacted]'s shareholder status was incidental to the sale transaction. Hence, the transfer of the [redacted] stock was made by [redacted] to [redacted] in a capacity other than that of a shareholder. Therefore, § 1001 should apply to the sale of the [redacted] stock to [redacted]. [redacted]'s exchange of its [redacted] stock for [redacted] stock should thus be treated as if: (1) the [redacted] stock was sold for a cash value equal to the fair market value of the [redacted] stock received and (2) [redacted] distributed that cash value to [redacted] in redemption of [redacted]'s [redacted] stock.

The above argument would recognize [redacted]'s status as an [redacted] shareholder, although incidental to its vendor status, and would thus also recognize [redacted] as a redeeming shareholder. As such, the above argument does not attempt to recharacterize the [redacted] transaction as a sale by [redacted] of the [redacted] stock to [redacted] for cash with [redacted] then utilizing that cash to make a separate tender-offer redemption to its old shareholders. That is, this argument does not and should not rely upon the the step-transaction doctrine.

Furthermore, the [redacted] transaction can be argued as representing an even stronger case for not applying section 311 than the examples provided in Treas. Reg. § 1.311-1(e)(2), since it is particularly clear in this case that [redacted] agreed to transfer the [redacted] stock to [redacted] in a non-shareholder capacity. At the time [redacted] entered into the contract to purchase [redacted] stock it was not even yet a shareholder. In addition, the facts clearly demonstrate that [redacted] acquired the [redacted] stock only pursuant to [redacted] directions and only to serve as a payment medium for acquiring the [redacted] stock and not to ever provide [redacted] with the benefits and burdens of stock ownership in [redacted]. Finally, this argument should serve as a test of the substantive validity of Treas. Reg. § 1.311-1(e). In that regard, the Government can rely on the presumptive validity of that regulation in support of its argument. As such, the Government should argue that this case falls squarely within the rules of Treas. Reg. § 1.311-1(e). Moreover, Congress has given its implicit approval to that regulation by amending section 311 without ever indicating any disagreement with that regulation.

An argument utilizing substance over form or more specifically the step-transaction doctrine should be used only as an alternative argument. It should be made clear that such argument does not rely on Treas. Reg. § 1.311-1(e). Under such alternative argument there is no distribution of appreciated property to redeem [redacted] stock, because the application of the step-transaction doctrine to this case results in a sale of the [redacted] stock to [redacted] for cash, and a cash tender offer redemption by [redacted] to its old shareholders.

We believe that for a substance over form argument or a step-transaction argument to have any reasonable chance for success the Government must explain why [redacted] is not being treated as an [redacted] shareholder. We believe that the best explanation is to argue that in substance [redacted] was never a shareholder of [redacted], because [redacted] was never subject to the burdens and benefits of owning [redacted] stock. Once the Tax Court is convinced that [redacted] was never an [redacted] shareholder, we believe that the Tax Court will then be more open to the above restructuring of the [redacted] transaction.

Finally, we note that on p. [redacted] of petitioner's trial memorandum he quotes from an article by [redacted], entitled "[redacted]". With regard to Treas. Reg. § 1.311-1(e)'s reference to shareholders acting in a vendee capacity, the quoted material states:

[redacted]

The petitioner apparently believes that this supports his case. To our view, it better supports the Government's case. [redacted]'s status as a vendee was created independently of any shareholder status, as evidenced by the fact that [redacted] made its offer to purchase the [redacted] stock before it had even become an [redacted] shareholder. Furthermore, [redacted]'s vendee capacity was arguably created without reference to exchanging the [redacted] stock for the [redacted] stock. That is, the purchase price to be paid by [redacted] for the [redacted] stock was clearly reached independent of the agreement to use the [redacted] stock as the consideration.

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